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“NRSROs: An overview of the policy debate”

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Summary of Banking Issue

- Basel II Standardized Approach and securitization rules use NRSRO ratings to set capital requirements
- Currently there are two “mandatory” NRSROs
  - Nationally Recognized Statistical Rating Organizations
  - Moody’s and Standard & Poor’s Corporation
- In the US, there are three “optional” NRSROs
  - Fitch Incorporated
  - Dominion Bond Ratings Services Limited (recognized Feb 2003)
  - AM Best Company (recognized March 2005)
- Improving a Split NRSRO rating will reduce capital significantly
- Will firms use an “optional” NRSROs to “shop” to improve credit rating

“Ratings Shopping” in Perspective

- “Ratings shopping” is part of a larger issue related to the industrial organization, conduct, performance and regulatory status of NRSROs
  - Oligopolistic Industry
    - Moody’s & S&P have 80% market share
    - Highly profitable
  - Special Market Function & Product (maybe/maybe not)
  - Special gov’t recognition with no ongoing gov’t regulation
    - treatment may create barriers to entry
  - Absence of NRSRO liability for ratings (recognized in law)
  - Questionable Record of Performance

Internationally Recognized NRSROs

- Moody’s Investors Services
- Standard & Poor’s Corporation
- Fitch Incorporated
  - All are old firms established before 1914
    - S&P established 1860 by Henry Varnum Poor
    - Moody’s established 1900 by John Moody
    - Fitch Publishing Company established 1913 by John Knowles Fitch
- All recognized by US Securities and Exchange Commission
    - NRSRO term was coined in 1975 in SEC broker-dealer capital rules
    - In the early 1990s, the SEC recognized as many as 7 NRSROs
- Two new NRSROs recently recognized
  - following Sarbanes-Oxley reforms *(now 3 optional NRSROs in US)*
    - Dominion Bond rating Services Limited, Feb 2003
    - AM Best Company, March 2005

Other Influential Ratings Services

- Other highly respected ratings companies in business but not recognized as NRSROs by the US SEC
- Over 130 exist (HR 2990); Many are specialized (partial list)
  - Duff & Phelps (investment banking advisory and ratings)
  - Weiss Rating Corporation (insurance and financial services)
    - Highest rated insurance rating company according to 1994 US GAO Study
  - Egan-Jones Ratings Company
  - Dun & Bradstreet (private and public company credit reports and ratings)
  - Morningstar (mutual funds)
  - Baycorp Advantage (Australian corporate rating company)
- No special regulatory status or recognition for non-NRSRO rating companies

NRSRO Designation

- March 2005: SEC proposed a rule that defines "Nationally Recognized Statistical Rating Organization"
  - SEC "no action letter" establishes NRSRO status
    - No action letter is public and a legal basis for others to use agency
  - Criteria for granting no action letter pursuant to a request
    - Must have "nationally recognized" credible and reliable ratings
    - Appropriate organizational structure
    - Adequate financial resources to enable independence
    - Adequate size and capabilities of the staff
    - Independence from rated companies
    - Systematic procedures to produce accurate and credible ratings
    - Internal controls appropriate to ensure ratings quality
- March 2005 proposal states that SEC lacks authority to conduct ongoing oversight over NRSROs

Many think NRSROs are Problematic

- Industry structure
  - Moody’s and S&P have 80% market share; Fitch 15%
- Many question industry practices
  - Agencies produce unsolicited ratings of a company ….sometimes along with a bill for services
  - May force companies to purchase other services (tying)
  - May lower ratings on asset-backed securities unless a substantial portion of the securities in the structure are also rated by the agency (notching)
  - Ratings are “expensive”
    - Moody’s reportedly has gross revenues in excess of $12 billion and operating income in excess of $5 billion annually
      - McTague, *Barron’s*, Jan 10, 2005

NRSRO Client Issues

- Results of 2004 survey of corporate CFOs and finance managers by *Association of Financial Professionals*
  - 34% believe their own companies ratings are inaccurate
    - 36% of those upgraded question accuracy
    - 50% of those downgraded question accuracy
  - 42% believe ratings changes for their organizations are not timely
  - 57% responded that they understand rating criteria
  - 32% believe ratings reflect industry condition, not firm credit quality
  - 50% of respondents know how to appeal an initial rating
  - 59% agree that SEC should take greater role in promoting competition
  - 75% think agencies need ongoing SEC oversight
  - 91% think agencies should document their internal controls that prevent conflict of interest

NRSRO Performance

- Performance: NRSROs failed to produce timely downgrades in many publicized defaults (memorable defaults)
  - New York City municipal bonds
  - Washington State Municipal Power Authority
  - Executive Life
  - Issues affected by the Asian Financial Crisis
  - Enron
  - Worldcom
    - Moody's Chairman, Clifford Alexander, was a board member of Worldcom up until he stepped down a year before the Worldcom default

Ratings Matter

- Rating and rating changes may convey nonpublic information that affects firm and firm securities values
  - Hand, Holthausen and Leftwich (JF 1992)
    - Negative abnormal returns for stocks and bonds for unexpected downgrades, and positive effects for upgrades
  - Dichev and Piotroski (JF 2001)
    - Firm stock pieces experience a negative abnormal return of between 10-14% in the year following a Moody’s downgrade
    - Moody’s upgrades have no long-term abnormal return
  - Kliger and Sarig (JF 2000)
    - Study expansion of Moody’s ratings scale—no new firm specific information, just a finer micrometer
      - Firm value unchanged under new rating scale
        - » But equity values rise & bond values fall when ratings notched dwn
        - » Equity values fall & bond values rise when ratings notched up
        - » I don’t understand this result!!! Must read details…….

NRSRO Accountability

- NRSROs have no legal responsibility for ratings inaccuracy
  - Do not accept responsibility for detecting fraud
- NRSROs claim their opinions are protected by 1st Amendment
  - NRSROs maintain they are members of the “media” that merely provide “opinions” and thus cannot be held liable if their conduct is alleged to be “reckless”
    - First Equity Corporation of Florida vs Standard & Poors Corporation 869 F.2d 175 (2d Cir. 1989)
  - NRSROs hold that they are journalists and not investment advisors. Agencies do not provide personalized investment advice which is the standard set by the courts for identifying an investment advisor.
    - standard set in Lowe v. SEC 472 US 181, 204 (1985).

NRSRO Accountability

- NRSROs are exempted from liability under a so-called "negligence standard of care"
  - Normally an expert's opinion may be published in a SEC registration statement only (i) with the expert's consent; (ii) if the expert is liable to investors for negligent and misleading opinions
  - Rule 436 of the Securities Act explicitly states that NRSRO ratings included in a prospectus are not to be deemed part of the Section 7 or 11 of security registration statements. Consequently:
    - Issuers do not have to get consent to state NRSRO ratings
    - NRSROs are not liable for negligent or misleading opinions
- NSROs are exempt from SEC Rule FD
  - "selective disclosure" rule does not apply and they may receive insider information without requiring issuing firm to disclose this information simultaneously to all its investors

NRSRO designation the best answer?

- June 16, 2006: The House Financial Services Committee passed “ The Credit Rating Agency Duopoly Relief Act of 2006” HR 2990
  - Seeks to: “inject greater competition, transparency, and accountability in the credit rating agency industry.”
  - Removes SEC from approving NRSROs
  - More vigorous oversight role for SEC
- Passed the House on July 12, 2006, 255 to 166

HR 2990 Provisions

- Agencies will register with the SEC
  - a decision to (dis) approve will be granted in 90 days after reviewing information on:
    - any conflicts of interest relating to the issuance of credit ratings by a nationally recognized statistical rating organization;
    - the procedures and methodologies such nationally recognized statistical rating organization uses in determining credit ratings;
    - credit ratings performance measurement statistics over short-term, mid-term, and long-term periods (as applicable) of such nationally recognized statistical rating organization;
    - policies or procedures adopted and implemented by such nationally recognized statistical rating organization to prevent the misuse in violation of this title (or the rules and regulations thereunder) of material, non-public information; and
    - the organizational structure of such nationally recognized statistical rating organization.

HR 2990 continued

- PROHIBITED ACTS AND PRACTICES- any act or practice relating to the issuance of credit ratings by a NRSRO that the Commission determines to be unfair, coercive, or abusive, including any act or practice relating to--
  - seeking payment for a credit rating that has not been specifically requested by the obligor
  - conditioning or threatening to condition the issuance of a credit rating on the obligor's (or an affiliate’s) purchase of other services or products including pre-credit rating assessment products of the nationally recognized statistical rating organization
  - lowering or threatening to lower a credit rating on, or refusing to rate, securities or money market instruments issued by an asset pool unless a portion of the assets within such pool also is rated by the nationally recognized statistical rating organization
  - modifying or threatening to modify a credit rating or otherwise departing from its adopted systematic procedures and methodologies in determining credit ratings, based on whether the obligor (or an affiliate) pays or will pay for the credit rating or any other services or products of the nationally recognized statistical rating organization

Basel II and "Ratings Shopping"

- The Basel II Standardized Approach and the rules for securitized instruments give capital relief to credits that are judged to have little credit risk according to an NRSRO
- Basel II capital rules for "split rated" credits or securities may encourage issuers to "ratings shop" from a third NRSRO to reduce regulatory capital requirement

Split Ratings

		percentage of issues where Moody's & S&P disgree
Banks		62.9
Other		50
	Manufacturing	56.3
	Mining	71
	Trade	63.6
	Services	56.3
	Transportation	57.1
	Public Utilitis	50.1
	Insurance	81.3
	Other finance	34.8
	All other	60

Source: Don Morgan, AER Sept 2002

“Rating Shopping” Issue Predates Basel II

- *April 28, 1995 statement before the US SEC by James McGuire, executive vice president and director of Moody’s Corporate Department:*

  “(by) using securities ratings as a tool of regulation, governments fundamentally change the nature of the product agencies sell. Issuers pay ratings fees to purchase…a license from the government. …if present trends of regulatory use of ratings are not arrested, the credibility and integrity of the ratings system itself will inevitably be eroded.”

Regulatory Use of NRSRO ratings

- SEC Rule 15c3-1 (Securities Act of 1933)
  - Set broker-dealer capital charges (haircuts) for debt securities (circa 1975)
- SEC Rule 2a-7 (Investment Company Act of 1940)
  - Limits money market funds to investing in "high quality" securities where minimum acceptable quality is NRSRO investment grade rating
    - Circa 1986, MMF must invest in A1/P1 or A2/P2 paper
    - Circa 1991, amended rule so 96% of MMF funds must be in A1/P1 paper
- Form S-3 Registration
  - Must be NRSRO invest grade in order to be eligible for short form registration
- Rule 3a-7 (Investment Company Act 1940)
  - Exempts asset backed securities that have an investment grade NRSRO rating from regulation
  - Gives NRSROs power to set industry-wide standards for structured obligations (gives rise to "notching" issue)
- National Association of Insurance Commissioners (NAIC) risk-based capital rules for assets of insurers

Other Proposed Regulatory Uses for NRSRO Ratings

- Set pension Benefit Guarantee Corporation (PBGC) premiums on under funded pension plans
  - Firms with below investment grade rating & under funded plans would face higher premiums
  - Did not get passed this year
- Set FDIC deposit insurance premiums
  - Deposit Insurance Reform legislation passed in Feb 2006
  - New procedures to set risk-based premiums are currently being developed
    - NRSRO ratings may be used as an input in the premium determination process

Special Role of NRSROs?

- Ratings Information is a public good
  - If you charge subscribers (users), public good nature implies under production of information in equilibrium
  - Answer: Charge issuers!
    - Solution raises conflict of interest issues
- Is the NRSRO situation unique?
  - No! Other financial service firms produce information
    - Public Accounting Firms
    - Investment Advisory/Research Services
  - Both suffered recent conflict of interest scandals
    - Public Company Accounting Oversight Board
    - Industry fines, firewall requirements, and minimum stock analyst rating scale and performance standards

Conflict of Interest and NRSROs

- Unsolicited ratings
  - Moody’s and S&P policy is to rate all registered US taxable debt securities
  - Fitch may produce unsolicited ratings
  - An NRSROs may withdraw a rating at any time
- If NRSROs business model is to charge issuers, it is unclear how offering free unsolicited ratings make economic sense if these convey information identical to solicited ratings
  - See Chester Spatt, SEC Chief Economist, SEC Conference presentation December 2004

Econometric Analysis of Unsolicited Ratings

- Unsolicited ratings are lower on average
  - Poon (2005) JBF
  - Boyoun and Shin (2005), SSRN Working Paper
  - Butler and Rogers (2003), unpublished job market paper (Wharton)
  - Roy (2005) SSRN Working Paper
- No legal requirement for NRSRO to reveal a rating is unsolicited by issuer
  - Moody's does not identify ratings as unsolicited or disclose ex post performance of its unsolicited ratings
  - S&P identifies unsolicited ratings but does not disclose performance
- Markets react to ratings changes, especially in post FD world
  - Jorion, Liu and Shi (2005) JFE
  - Moody's ratings may be taken to reflect inside information
    - Some think practice is tantamount to extortion
    (Northern Trust Corporation in 2003 SEC testimony)

Explaining the bias in unsolicited ratings

- Perhaps bias can be explained because unsolicited ratings exclude inside information and other “soft” information gained from insider relationship
  - Boyoun and Shin (2005), SSRN Working Paper
  - Roy (2005) SSRN Working Paper
- Worcester and Flaherty (2006) use Moody’s Japanese ratings data and show that access to inside information had no effect of the bias of Moody’s unsolicited ratings
  - Japan is not a ratings dependent country and S&P and Moody’s are issuing unsolicited rating in Japan to establish a “ratings culture”
    - Survey evidence by Fairchild and Shin (2005) finds that 67% of Japanese firms with unsolicited Moody’s rating supplied Moodys with inside information
  - Worcester and Flaherty (2006) find that Moody’s unsolicited ratings are statistically lower regardless of whether or not Moody’s had access to inside information on the issuer

Rating Shopping Evidence

- Mahlmann (presented at RTF)
  - Do firms shop for better rating?
  - Yes
- Early draft with issues…..result would not be a surprise, but the jury is out